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Can a Charitable Lead Annuity Trust Own Life Insurance?

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Yes. As the following describes, a Charitable Lead Annuity Trust ("CLAT") can hold life insurance. Preferably, the grantor will contribute a fully funded policy rather than have the CLAT purchase the policy and pay premiums.

CLATs are irrevocable split interest trusts that pay a fixed annuity amount to charity for the lifetime of the grantor or a fixed number of years. At the end of the annuity period, non-charitable beneficiaries (usually the grantor's family) receive the remainder free of estate or gift tax.

CLATs may be taxed as grantor or non-grantor trusts and may be inter-vivos or testamentary trusts. The IRS prescribes forms for planners to use in designing CLATs.[1] The CLAT's annuity payments must be ascertainable but need not be identical from year to year.[2]

If structured properly, a CLAT qualifies for the gift tax charitable deduction[3] and/or the estate tax charitable deduction.[4] A transfer to an inter-vivos CLAT interest may also qualify for an income tax charitable deduction.[5] The amount of the charitable tax deduction equals the present value of the annuity payments to charity, calculated by reference to the applicable §7520 rate.[6] CLATs are particularly well-suited in this low interest environment, where it will take less effort for earnings to exceed the §7520 rate.

A CLAT must make an annuity payment in cash or kind to charity each year during the annuity period. This necessarily limits the type of assets a CLAT may hold. Preferred assets include income producing investments. Undesirable assets include illiquid investments and hard-to-value investments.

The tax rules do not mandate constant annuity payments, and there is no prohibition against a CLAT making minimal annuity payments to charity each year, followed by a large balloon payment in the final year of the annuity period (with the remainder passing to the grantor's family). This type of CLAT is known as a "shark fin" CLAT because the graphical depiction of payments during the annuity period resembles a shark fin.

Rev. Procs. 2007-45 and 2007-46 prescribe IRS approved forms for CLATs. Although the IRS has not specifically approved shark fin CLATs, it has not specifically prohibited them. Furthermore, a comment in the Rev. Proc. 2007-45 endorses annuity payments that increase during the annuity term.[7] Of course, there is the possibility that the IRS may someday decide shark-fin CLATs do not work, and disallow charitable deductions for contributions. Until then, planners should discuss the benefits and risks with their clients. If the client is comfortable with the risks, planners should not fear shark-fin CLATs.

Once the decision is made to create a shark fin CLAT, the issue must be addressed of whether the grantor should contribute a paid up policy to the CLAT or the Trustee should purchase the policy and pay premiums using cash contributed by the grantor. The charitable split dollar rules of §170(f)(10) disallow a charitable income tax deduction for amounts transferred to a charitable organization used directly or indirectly to purchase life insurance that ultimately benefits the transferor or his family.[8] Although minimal guidance has been issued as to whether a CLAT – not technically a charitable organization – is subject to the charitable split dollar rules, there is a risk that the IRS will determine that it is. The consequences of this would be harsh: the charitable deduction could be disallowed to the transferor and the CLAT could be subject to an excise tax equal to the premiums paid.[9]

A safer approach is for the grantor to contribute a paid-up policy on his life and a small amount of cash to the CLAT. The Trustee would make the annuity payments to charity from the cash and in the year of the grantor's death, the Trustee would make a balloon payment to the charity. Un-

der this approach, there is no risk that the personal benefit contract rules would apply.

In conclusion, a CLAT whose primary asset is life insurance can be a very useful vehicle for benefiting charities and the grantor's family in today's low interest rate environment. To avoid the risk that the charitable split dollar/ personal benefit contract rules apply, the grantor should contribute a paid up policy to the CLAT.

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[1] For intervivos CLATs: Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (July 16, 2007); for testamentary CLATs: Rev. Proc. 2007-46, 2007-29 I.R.B. 102 (July 16, 2007)
[2] Rev. Procs. 2007-45 and 2007-46 at § 3
[3] IRC §2522(c)(2)(B)
[4] IRC §2055(e)(2)(B)
[5] IRC §170(a)
[6] IRC §7520 requires that this be determined with reference to IRS tables.
[7] For an additional defense of shark fin CLATs, see Pratt, Goldberger & Lee's article in LISI Charitable Planning Newsletter #163 entitled "*Biting Back: Responding to the Attack on Shark-Fin CLATs*"
[8] This would be considered a "personal benefit contract" under §170(f)(10)(A)(ii)
[9] §170(f)(10)(A) and §170(f)(10)(F)

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